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Mercantile Bank of Canada

ANNUAL REPORT 1977

Financial Highlights

	1977	1976
Total assets	**$2,063,179,583**	$1,708,093,219
Total loans	**$1,554,384,320**	$1,243,839,064
Total revenue	**$167,668,551**	$149,841,205
Balance of revenue after provision for income taxes	**$14,044,907**	$13,908,103
Per share	**$1.76**	$1.74
Balance of profits for the year	**$11,624,907**	$10,208,103
Per share	**$1.45**	$1.28
Average number of shares outstanding throughout year	**8,000,000**	8,000,000

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President and Chief Executive Officer's Address

This is my first opportunity to address an Annual General Meeting of the Mercantile Bank of Canada. I hope to be able to reaffirm our basic policies as well as to clarify questions that have arisen during the year as to our position in the Canadian market. Mr. Prisco's presentation will deal later with the specific results of the bank during 1977.

While we are a full service chartered bank, we continue to concentrate our main energies in the commercial sector where we service numerous types of business involving industry, real estate, services and foreign trade and investment. Our fourteen branches in the major cities of Canada, spread from coast to coast, allow us to efficiently service our corporate clients throughout Canada. In addition our representative office in Los Angeles, along with our Vancouver branch, gives us good access to business concerning trade with the Pacific Basin countries. While we are able to service clients throughout Canada, our few locations, compared with those of most of our competition, help us keep our overhead costs down.

Our staff has the reputation of being young, intelligent and innovative, as well as aggressive. We like that image. We consider our bank to be a growth institution. Slow growth, or lack of growth, is painful to us. While market forces may slow our pace, as is the case right now when the economy is not moving as fast as many of us would like, we will continue to devote our efforts to outperforming our competitors. Toward this end we are always on the lookout for new types of services that we can offer.

We, at Mercantile, are concerned with the question of the viability of the Canadian Confederation. As a nationwide financial organization, we perceive the maintenance of unity in our interest, and in the interest of the financial well-being of Canada as a whole. The major financial institutions in Canada support the many local economies in the areas in which their offices are located. National institutions, such as ours, following such policies, contribute to the strength of the whole, so that the nation can continue to accommodate the diversity of cultures and economies that make Canada a desirable place in which to live.

Last year my predecessor commented on the Bank Act revision. This legislation has been delayed and will probably come into force next year. Our support for the envisioned increased competition in the banking sector remains the same. The increased competition will likely come in many forms — both internally, from new banks emerging, as well as externally from foreign banks being permitted to carry out their business within our borders as chartered banks. In addition the boundaries of competition between financial institutions will probably be widened by new regulations permitting banks to enter new fields, such as leasing and factoring, hitherto not permitted. This, in itself, would widen the base for competition within the financial community, putting all financial institutions on a much closer footing. Being constantly in search of new ways to service our customers, we naturally welcome any new opportunities the new Act will give us.

The proposed banking legislation will affect us in areas other than in increasing competition and broadening our potential product line. Banks will be given more flexibility in the raising of equity. Deposit reserve requirements may well be altered to make banks more competitive with non-bank financial institutions.

We are well aware that the new entrants in banking will compete directly with us and possibly structure their institutions in a manner similar to ours. We believe our present position ensures our ability to compete. We have a well-staffed branch structure and a name in the market. Our foreign competitors will have strong support from their parents, but we continue to receive technical assistance from Citibank whenever we request it. This technical assistance gives us an entrée into Citibank's systems, products and knowledge.

On the other hand, we view Citibank's business in Canada as competitive to ours and we react accordingly. We compete directly in the market at arm's length. Mercantile operates under self-contained, separate management and under the direction of a completely independent board of directors. The same principles would be followed if Citibank were to establish a new chartered bank under the prospective banking legislation.

The economy of Canada is of concern to us, as it is to all Canadians. At a glance unemployment, inflation, the balance of payments and the value of the Canadian dollar in the world market do not present a very bright picture. There is a general understanding that adjustments, even individual sacrifices, must occur to realign structural imbalances in the economy in order to ensure a return to international competitiveness with an opportunity for renewed growth. The problem is a complex one, for which there are no easy solutions. Economists tell us there is a relationship between money supply and inflation. The Bank of Canada is judiciously attempting to control the growth in money supply. It is perceived that high taxes, taxes higher than other countries', inflate wage demands and prices throughout the manufacturing, distribution and sales cycle. All levels of Canadian government are attempting to slow growth in their expenditures. With a restricted growth in money supply individuals quickly understand the necessity of a forced sharing between wages, capital and government. This adjustment takes time to work its way through in a manner acceptable to all. Abrupt change could well result in an unacceptable level of pain. We foresee 1978 as a period of continuing adjustment, with some hope for positive improvement, if all participants have the required patience and understanding.

Robert L. Davidson

The Mercantile Bank is using this period of relatively slow growth to better position itself for the ultimate recovery. We continue to hire well qualified staff, and upgrade in-house training. We are expanding our computer capability and refining its applications to our asset and liability management. We are building our industry knowledge and expanding our international business. We are preparing for a future of which we are optimistic.

Canada has certain advantages that should ensure its position as one of the strongest nations of the world. Canada can feed itself, and still have surplus food for export. Canada's natural resources are large in comparison to most other nations'. Canada does not have a surplus of population, and the population it has is well educated by international standards. Canada has energy resources that can ensure self-sufficiency, at a price. While Canada's structural problems exist, I can not think of any nation that would not willingly exchange its problems for Canada's. In short, we should evidence more self-confidence in dealing with our present-day problems, as they are minor compared to the problems faced by almost every other nation.

Executive Vice President and Chief General Manager's Report

The year 1977 was characterized by low corporate loan demand and narrow interest spreads. Although Canadian dollar business loans in excess of $1 million from all banks are up roughly 16% it has been our experience that there has been a definite change in the composition of this loan demand. There has been a shift away from the capital investment, project or cash flow lending area. The poor Canadian corporate loan growth for plant and equipment is just one more indicator of the lacklustre condition of the Canadian economy. Although the federal government is attempting to create a healthy corporate investment environment, by its competent monetary policy and by promises of good intention, it has a long way to go before full confidence is restored. There is still a perception held by both Canadian and non-Canadian corporate investors alike that Canada is a poor risk, relative to other countries. This perception is essentially because of the inability of investors to predict the future involvement of government in the commercial life of the country. There are still contradictory policies existing and statements being made which thwart the government's attempts to stimulate the economy. What with high government expenditures in relation to gross national product, the Anti-Inflation Board, the Foreign Investment Review Agency, the constitutional problems and past pronouncements of political leaders, business decision makers still appear to wish to carry out their new investment activities elsewhere. Real investment by business has been flat for two years and in the face of this Canada can not but have its position as a major trading nation deteriorate. In the long run the only way to compete internationally is through producing quality products at a competitive price. Without adequate investment in plant and equipment, productivity will not be improved and Canadian goods will have difficulty competing on a price and quality basis with those of the other trading nations of the world.

As a result of this lack of meaningful corporate investment in Canada, demand for our product has been depressed. Mercantile Bank is recognized as having considerable strength in project, cash flow lending and this is an area upon which we depend for much of our growth. We have in part made up for the shortfall in Canadian dollar business lending by increasing our U.S. dollar loans. These loans are to both domestic and U.S. resident corporations, as well as loans in the international area.

As I mentioned, the year was also characterized by narrow spreads. Over a six month span the Bank of Canada reduced its Bank Rate four times for a total reduction of 2%. This was of course matched by a lowering of the Canadian bank prime rate. These prime rate cuts were not entirely anticipated by the money market. Interest margins were therefore very narrow for the periods directly after these prime rate cuts. The Bank Rate reductions by the Bank of Canada were necessary and were done to increase loan demand and thereby stimulate the economy. The bank yield cost spread, that is the interest rate it earns on its earning assets less the interest rate it pays for deposits, was 2.07% for 1977, a decline from the 2.42% of 1976 and a substantial drop from the 3.28% spread of 1975. These spreads have been adjusted to take into account the tax-free nature of income from our income debentures and preferred shares.

In spite of the slow loan demand and the narrow spreads, the bank earned $1.76 per share in 1977.

The total assets of the bank as at October 31, 1977 stood at $2,063 million and for the first time exceeded two billion dollars. This is a $355 million or 20.8% increase from the $1.7 billion last year. Looking back a short six years in our history, this year's total assets are an increase of close to $1.8 billion from the $288 million at the end of 1971, the last full year before our public share issue program. Our total loans excluding day loans and call loans to investment dealers are up 15.6% at $1.4 billion. Most of the $190 million increase in our lending activity was generated by loans denominated basically in U.S. dollars which stand at $241 million. This is an increase of $149 million or 162% from last year. Corporate U.S. dollar loans stand at $166 million and were up 191% while international loans grew by 114% to $74 million. A further $15 million of international loans are loans to central banks and are categorized as due from banks on the balance sheet.

Non-government securities of Canadian issuers stood at $229 million on October 31, up from $140 million last year. However, many of these securities were privately placed with the bank by corporations and represent another form of direct financing to corporations. These corporate type securities which are income debentures and preferred shares total $173 million, and of this total $143 million have rates which change when the prime changes.

The bank liquidity at October 31, that is cash, all marketable securities and day and call loans, stood at $361 million, up from the $272 million of last year. This represents 19% of our total deposits. Over the past two years, since the completion of our final share issue, it has been the policy of the bank to increase liquidity and the position at the end of fiscal 1977, although slightly high, is representative of what our liquidity has been in the recent past and will be in the future.

Total capital funds of the bank approached the psychologically important level of $100 million and stand at $98 million. If accumulated appropriations for losses are included, our capital funds plus reserves are $115 million. Accumulated appropriations for losses, in effect a reserve for exceptional non-recurring losses, increased $3.3 million or 24.5% and is $16.6 million.

Turning to the non-interest portion of the profit and loss statement our other operating revenue for 1977 was $9.2 million, an increase of $2 million or 28% from 1976. Although fee income for services provided to our corporate clients continues to be important, the bulk of the increase in other operating income is due to foreign exchange earnings. Given the unstable condition of the foreign exchange markets this increase in foreign exchange earnings should not be a surprise to anyone.

Total operating expenses for 1977, that is total expenses less interest expenses, were $20.5 million, up $4.8 million or 30.5% from last year. Total salary and associated expenses, at $8.5 million, increased $1.2 million, a rate of growth of 16.4%. Average total staff of the bank was up 11% and on October 31 total staff stood at 571 persons.

Property expenses of the bank, at $2.7 million, increased $462 thousand in the year primarily because of increased rent. We opened two new branches in 1977 and expanded premises in Montreal, Toronto, Calgary and Vancouver.

Other operating expenses increased $3.1 million to $9.3 million in 1977, an increase of 51%. Approximately one half of the increase was due to an increase in provision for loan losses which I will comment on in a moment. The remaining $1.6 million was due to an increase in the general expenses of the bank.

The past year saw expansion in the physical presence of the bank. In May we opened a branch in Regina and in October one in Ottawa. This now gives us the national coverage we had planned for and we do not anticipate opening any full service branches in fiscal 1978. Last year also saw the formal establishment of an International Division in the bank. Although our international lending is modest by banking standards, we see an opportunity in becoming more involved in the importing and exporting activities of Canadians. Combining our skill as bankers and our international contacts through Citibank we feel we can be of service in this vital area.

One area I would like to discuss and one where the bank has had a great deal of publicity in the past year is possible loan losses. Last spring there were rumors that the loan loss picture of the bank was unhealthy. The actual loss experience of Mercantile Bank in 1977 was $5.4 million compared to $4.2 million last year. The charge against profit and loss this year was $3.9 million, up from $2.3 million. The loan loss ratio, the real measure of a bank's loan loss situation, was 0.25%, a figure which compares to our experience of 0.18% last year, and 0.33% for the industry in 1976. There is no doubt that this past year has been a tough one for businesses. Banks which finance businesses are naturally going to have poor economic conditions reflected in their loan losses. But a bank is in the business of lending money and there is and always will be a risk associated with this. A bank that does not have loan losses could be viewed as not maximizing its opportunities, and therefore not performing at its full potential. We believe that we at Mercantile have a good balance between risk and return. Although we, or any bank for that matter, do not like loan losses we recognize it as a cost of doing business. We have systems that ensure continuous loan reviews at all levels which identify existing and potential problem areas. The loan loss situation is currently on a manageable level and we do not expect any material changes in it except for those changes that may be caused by growth.

Before concluding I would like to say that we view 1977 with mixed emotions because of the low corporate loan demand and narrow spreads; however, we look to 1978 with confidence. So far this year corporate loan demand seems to have picked up and interest spreads, while not wide, are at acceptable levels. I would like to thank the dedicated staff who form the Mercantile team for their continued efforts. We at the bank have a high esprit de corps and I know this contributes in no small way to our success.

Walter A. Prisco

Operational Review

The essence of an organization is its people. It is the employees who differentiate one organization from another — they make it better and more successful than the next. At Mercantile Bank we are well aware of this and are proud of our people and their skills in lending and many other areas. We make sure, by the way in which we hire and train our men and women, that our products are sold by highly qualified staff who have the special skills necessary to service our clients in the way they desire.

We actively recruit young people with university and business backgrounds in finance, accounting and marketing. We seek people who are qualified, aggressive, professional, and are looking for challenge and diversity. As a result, 82% of our lending officers have undergraduate degrees and almost 50% have MBAs. They are, on average, in their early to mid thirties and are thoroughly seasoned with about ten years business experience behind them.

Our Training Department plays a major role in the bank. Here, new recruits are given extensive training in the financial skills and techniques they will need to provide service to our clients. In addition, our officers regularly receive refresher courses in new developments in banking and finance. Much of the instruction is given by our own staff members but experts from outside also contribute. During the last year about 85 different people took courses in our training school, some of them taking more than one. Thus, nearly half of our professional staff participated in in-house training during the year.

The courses we offer cover such subjects as real estate lending, corporate lending, collateral security, financial analysis and foreign exchange and money market. In addition, we also provide management and communications training in such areas as business writing, time management, selling skills, supervision and employee relations. Many of our staff also take advantage of courses offered outside the bank by universities and the Institute of Canadian Bankers.

Mercantile Bank has chosen to specialize in the business side of lending and to operate through a small number of locations in the key centres of Canada. Over 90% of our business is commercial in nature. Most of it, close to 90%, concerns loans of over $1 million and about 60% involves deals of $5 million and more. We feel that our credit officers, equipped with academic qualifications and our own in-house training, are particularly well suited to giving our corporate clients the best possible service. We also believe that we should visit our customers frequently in order to be able to understand their problems, rather than them always coming to see us. Thus we have found we only need one location in each centre of our operations. After opening two new branches in the last fiscal year,

From left to right are Senior Vice Presidents Patrick F. Bowditch, Bernard J. Goyette, Duncan Campbell, T. Sean Ahern and John E. Pierce.

Regina and Ottawa, we have completed our present expansion program. Because of our chosen specialized market and our philosophy of few branches, we have made sure our premises are smart and tastefully designed.

Having established our branch network, we are now looking for ways in which we shall be able to service our customers on the spot and yet maintain cost effectiveness. We have decided to open some small representative offices within Canada on a trial basis; they will be similar to our office in Los Angeles.

One of our strengths is our association with the second largest bank in the world, and the largest as far as international business is concerned. We are affiliated with Citibank, N.A., making it possible for us to offer services related to international business without having to establish a vast network of overseas locations ourselves.

While our business is general lending, we adapt ourselves to changing conditions, and offer special services wherever and whenever they are needed. We have, for instance, set up an Oil and Gas Department in Calgary, the oil heartland. We are involved in project financing in most industrial and resource sectors of the Canadian economy — oil and gas, forestry, pulp and paper, mining, transportation and so forth. As a result we are developing extensive pools of knowledge in these areas, a fact which in itself assists us in improving our service to our clients.

The main objective of a corporate bank like Mercantile is to lend money. But of course we do offer other services and many of these are carried out by the support people on whom our lending officers rely not only for these services but also for all the necessary administrative work. Transfers of funds can be made either domestically or on an international basis as can foreign exchange transactions. Securities are held for safekeeping and collateral, letters of credit are prepared for both import and export activities and deposits, loans and cheques are processed on a daily basis.

One result of our corporate decision to have just a few branches in key centres is that we rely extensively on the money market for our sources of funds. Our traders, who carry out these transactions on the various markets, also provide a service to our clients by buying surplus money from them in the form of bearer deposit notes or certificates of deposit.

The business of the bank is basically divided into three divisions — Eastern, Central and Western. This geographic organization is used only at the lending level. At Head Office we provide support to the lending area on a functional basis. Here we find such departments as Personnel, responsible for hiring and training staff; Credit Supervision, which supervises individual loan decisions and the general lending policy of our bank; Investment and Exchange; and Administration which, among many other functions, produces management reports to assist in day-to-day as well as long-term planning.

We have attempted to give you a picture of our organization and its most valuable asset — our people. In the next few pages we examine in detail some of the financial results they have produced for Mercantile.

An Analysis of the 1977 Financial Results

Assets

Total assets stood at $2,063 million on October 31, 1977, up $355 million or 20.8% from their level of a year ago. Assets per employee, based on staff of 571 at year-end, stood at $3.6 million, compared to $3.4 million on October 31, 1976.

While assets grew at a slower rate than the 32.6% increase achieved in 1976, Mercantile's asset growth approximates the 21.2% growth rate experienced by the banking industry as a whole.

Loans

Increased loan balances were the primary source of the asset growth which occurred. Total loans increased by $311 million or 25% over year-end 1976. Excluding day, call and short-term loans to investment dealers which in effect form part of the bank's liquidity, basic lending to corporate clients increased by $190 million or 15.6%. Loans per employee remained flat at $2.45 million at the end of 1977, compared to $2.42 million in 1976.

It should be noted that these loan figures do not include those income debentures and preferred shares which are direct financing to corporate clients. These assets are reported as securities. When they are added to the growth in our business loans, the bank's over-all financing to corporations increased by $245 million or 18.5% during 1977.

Corporate financing including these direct placements was 76% of the total assets of the bank at the end of October 1977, a slight decline from the 78% achieved last year.

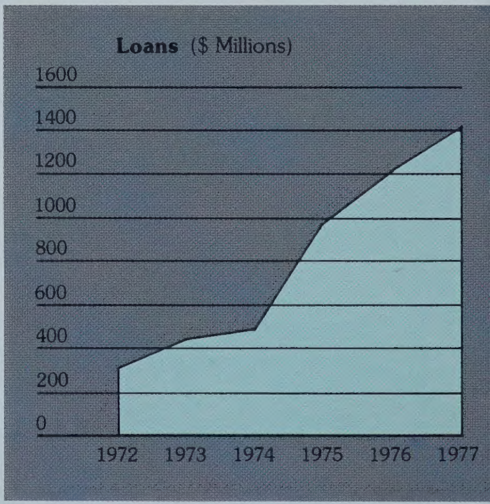
Securities

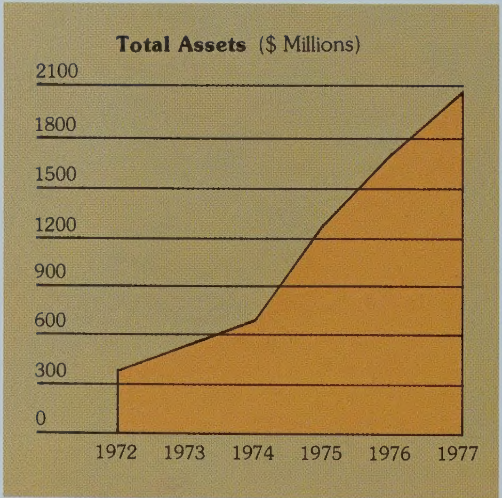
Total securities stood at $337 million on October 31, 1977, up $28 million from a year earlier.

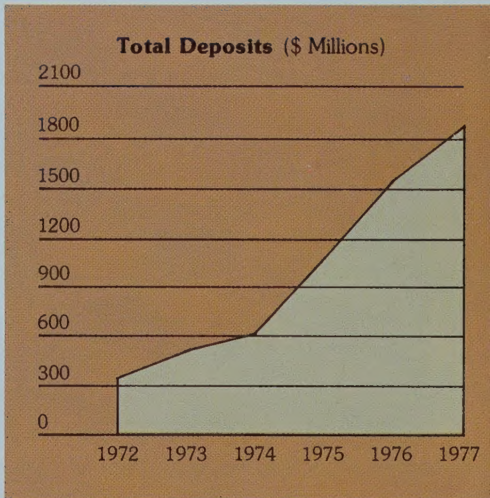
Other securities increased 63.2% from 1976 to $229 million. This increase reflects higher levels of income debentures which grew from $88 million in 1976 to $112 million in 1977, and preferred shares which moved from $45 million to $87 million. Income debentures are generally direct placements by corporations while preferred shares can either be direct placements or can be purchased on the open market and held for investment purposes. Even though these preferred shares are purchased in the market for investment purposes the bank views them as a tertiary level of liquidity. The direct placements of preferred shares were $61 million and the market preferred shares were $26 million. Of the $173 million direct placements, the interest rate on $143 million of this amount changes when the prime rate changes. The interest rate on the market securities is fixed and does not change when the prime rate changes. Income debentures and preferred shares differ from bank loans in that the interest earned on them is treated as dividend income under the Income Tax Act and as such is non-taxable revenue. Conversely the interest cost to the borrower is a non-deductible expense for income tax purposes.

Securities issued by, or guaranteed by, a province declined from $71 million at the end of 1976 to $7 million on October 31, 1977. The decrease in this liquid asset category was more than offset by increased call and short-term loans to dealers (another form of liquidity) which rose by $121 million year-over-year.

The bank's overall liquidity stood at $361 million on October 31, 1977, that is 19.1% of total deposits, up from $272 million or 17.3% of total deposits last year. Liquidity is defined here as cash, deposits with banks (excluding loans to central banks which are really international loans), market securities and day/call loans to investment dealers.







Liabilities

Over the year total deposits increased to $1,894.6 million or by 20.8% over the levels reported at the end of fiscal 1976. Total deposits at year-end were equivalent to 91.8% of total assets, unchanged from a year ago. Demand deposits, which are included in other deposits, totalled $47 million on October 31, 1977, down 5.9% from last year's levels.

The bulk of the bank's deposits are raised in the money market either directly from corporate lenders or indirectly from investment dealers. Over the last year we have worked to increase the share of our deposits raised directly from corporate sources. In the fall of 1976 we strengthened our money market operations in Toronto, an action which has brought us closer to one of Canada's principal financial markets and has allowed us to more fully develop our direct deposit sources.

Accumulated Appropriations for Losses

Accumulated appropriations for losses amounted to $16.6 million on October 31, 1977, up $3.3 million from October 1976. The increase is attributable to an appropriation of $2.4 million plus the accompanying tax credit of $2.1 million from current year earnings. This was offset by the $1.6 million difference which existed between our actual 1977 loan losses and the provision for loan losses contained in the 1977 revenue and expense statement. Actual loan losses during 1977 amounted to $5.4 million, $1.2 million greater than 1976, while $3.9 million was charged against revenue and expenses in 1977 compared to $2.3 million in 1976.

Capital Funds

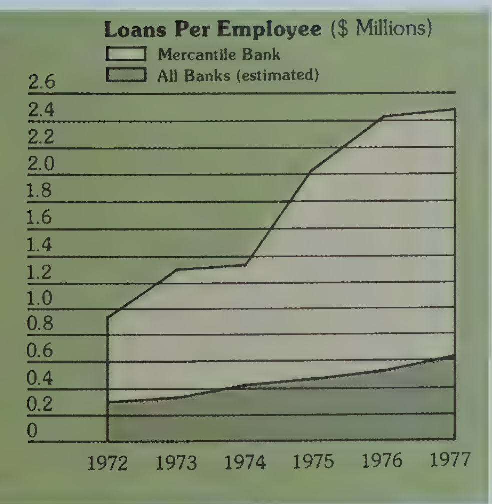
Capital funds of the bank stood at $98 million at the end of 1977, up $36 million from the 1976 level of $62 million. A $30 million debenture issue which was completed on January 11, 1977 provided the main source of increased capital. These debentures have a term of twenty years, retractable to ten, and carry a coupon rate of 9%.

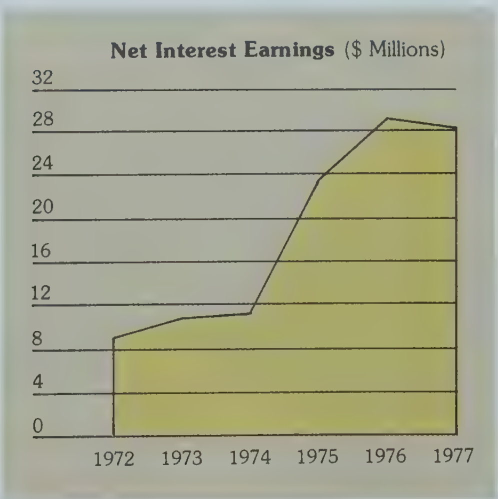
The remainder of the increase in capital funds resulted in retention of earnings after appropriations for losses of $5.6 million. During 1977 $6 million was transferred from undivided profits to rest account bringing the rest account to $27 million.

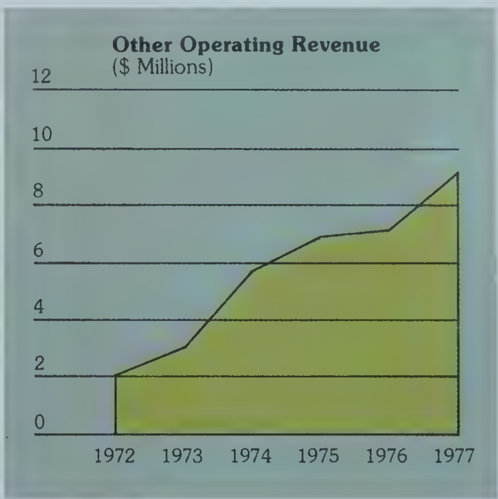
Based on the balances of October 31, 1977, the bank's leverage stood at 18 to 1, which compares to a ratio of 23.2 to 1 for the industry. Leverage is measured by dividing total assets by total capital where capital includes equity, debentures and accumulated appropriations for losses.

Net Interest Earnings

Total interest earnings were $158.5 million, an increase of $15.8 million or 11.1% over 1976. This increase was due to an increase in interest earning assets which were up 27% on average for the year. The effect of this higher volume was offset in part by generally lower interest rate levels in 1977 from 1976. For example, the Canadian dollar prime decreased on average 1.28% for the year to 8.79%. Income from loans rose by $8.4 million or 6.6% and income from securities by $7.4 million or 46.4%. Average volume of securities was also up 46%. This increase in securities was necessary both to meet the needs of our clients as well as to maintain sufficient liquidity levels.







The higher interest earnings were more than offset, however, by higher costs of deposits which increased by $16.7 million or 14.7%. As a result, net interest earnings (interest revenue less interest expense) declined by $0.8 million or 2.9% from their 1976 level, despite the 20.8% growth in average assets which occurred in 1977. The decline in net interest earnings reflects the compression of the interest spread between the interest rate at which we lend money and our cost of funds. The compression was caused by rapidly falling money market rates during the year precipitated by declines in administered rates. Between November 22, 1976 and May 9, 1977 the Bank of Canada Bank Rate fell four times for a total reduction of 2%. This drop in the Bank Rate was matched by a fall in the bank prime rate. As the interest rate on most of our loans is tied to prime we had an immediate reduction in interest revenue. However, there was a lag in the average cost of our money market funds. Although after a decline in our prime rate the interest rate on our new deposits was acceptably low in relation to prime, the deposits which were on our books before the general rate decline were in some cases above the prime rate. It took time for these higher rate deposits to mature and this had an effect of squeezing our spreads between the prime rate and our average cost of money market deposits. If the net interest earnings were adjusted for the tax effect of the income from the income debentures and preferred shares, the net interest earnings would increase 10% in 1977 over 1976.

Other Operating Revenue

Other operating revenue amounted to $9.2 million in 1977, an increase of $2 million or 28.1% over 1976. The gain over last year is mainly due to higher profits on foreign exchange trading made possible by the volatility of currency markets in 1977. Fees on loans, the other major item in other operating revenue, were approximately the same as in 1976.

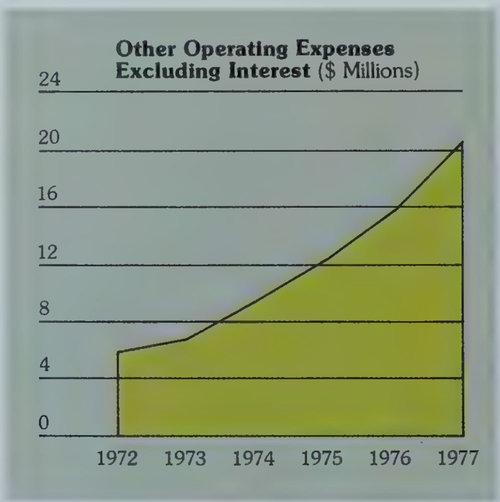
Operating Expenses

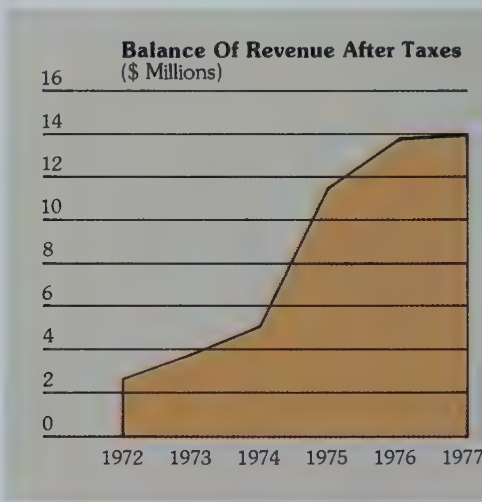
Total operating expenses increased by $4.8 million or 30.5% over 1976. Close to $1.6 million of this increase is due to a higher provision for loan losses. Excluding this provision, operating expenses increased by $3.2 million or 24%.

Salaries and staff benefit payments rose by $1.2 million or 16.4%, reflecting increases in staff as well as normal merit and promotional increases. Total employees stood at 571 at the end of 1977, compared to 498 a year earlier.

Property expenses increased by $0.5 million or 20.4% over 1976 levels. The opening of new branches in Regina and Ottawa and the expansion of existing premises in Montreal, Toronto, Calgary and Vancouver were the prime factors underlying the increase.

Other operating expenses, which include the provision for loan losses referred to earlier, increased by $3.1 million or 50.9%. When the provision for loan losses is factored out, other operating expenses increased by $1.6 million or 40.2%. Staff moving, management consulting and capital tax expenses accounted for roughly 40% of this $1.6





million. Staff moving expenses were unusually high because of the opening of the new branches and a shift in senior management responsibilities which had a multiplier effect in moves throughout the bank. Management consulting expenses were high because of a number of non-recurring projects undertaken in the year such as a total compensation review, a study of our data processing activities and outside technical assistance related to data processing.

Balance of Revenue

Balance of revenue before taxes was $17 million, down $3.6 million or 17.6% from 1976. This decline was due to narrower net interest spreads experienced in 1977, higher operating costs and proportionately higher levels of income debentures and preferred shares. These latter two types of securities yield relatively low pre-tax returns but are very attractive on an after-tax basis. Again if the balance of revenue is grossed up for the tax effect of the income debentures and preferred shares it would be up roughly 3%.

Provision for Income Taxes

The provision for income taxes amounted to $2.9 million, $3.8 million below the 1976 provision. The effective tax rate declined to 17.2% in 1977 from 32.4% last year, primarily as a result of the higher proportion of revenue derived from securities much of which is received tax-free.

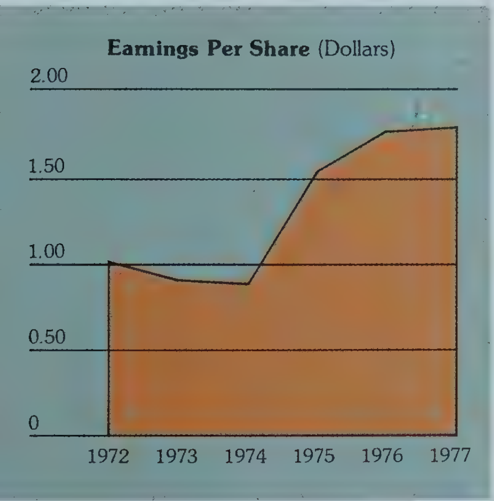
Balance of Revenue After Taxes

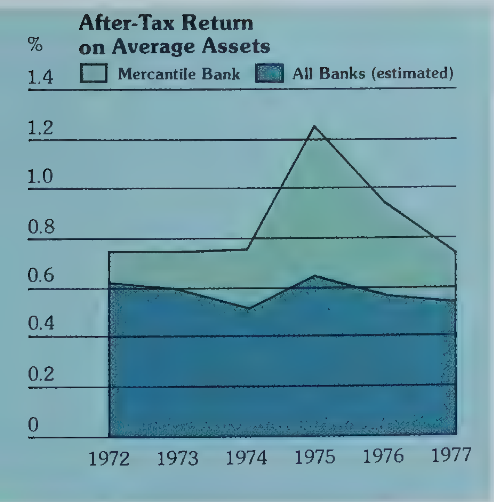
Balance of revenue after taxes was $14 million, up $0.1 million or 1% from 1976. Earnings per share amounted to $1.76 compared to $1.74 last year.

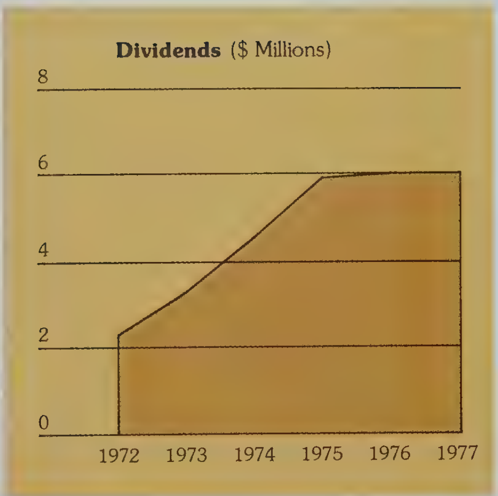
After-tax return on average assets was 0.75%, down 0.18% from the previous year, but above the industry average of 0.55%.

Dividends

Four quarterly dividends of 12.5¢ as well as an extra dividend of 25¢ were declared in 1977.







Statement of Assets and Liabilities

as at October 31, 1977 (with comparative figures for 1976)

Assets

	1977	1976
Cash and due from banks	**$ 66,424,419**	$ 84,028,887
Cheques and other items in transit, net	**47,591,995**	9,790,894
Total cash resources	**114,016,414**	93,819,781
Securities issued or guaranteed by Canada, at amortized value	**100,348,019**	97,703,339
Securities issued or guaranteed by provinces, at amortized value	**7,298,431**	71,154,740
Other securities, not exceeding market value	**229,098,612**	140,375,472
Total securities	**336,745,062**	309,233,551
Day, call and short loans to investment dealers and brokers, secured	**151,927,000**	30,908,460
Other loans, including mortgages, less provision for losses	**1,402,457,320**	1,212,930,604
Total loans	**1,554,384,320**	1,243,839,064
Bank premises, at cost, less amounts written off	**4,245,636**	3,256,169
Customers' liability under acceptances, guarantees and letters of credit as per contra	**48,903,794**	55,537,317
Other assets	**4,884,357**	2,407,337
	$2,063,179,583	$1,708,093,219

Robert L. Davidson
President & Chief Executive Officer

See notes to financial statements.

Liabilities

	1977	1976
Deposits by Canada	$ 6,615,605	$ 4,602,312
Deposits by provinces	18,996,420	37,552,135
Deposits by banks	246,079,760	81,203,749
Personal savings deposits, payable after notice in Canada in Canadian currency	7,284,227	11,463,818
Other deposits	1,615,637,442	1,433,332,926
Total deposits	1,894,613,454	1,568,154,940
Acceptances, guarantees and letters of credit	48,903,794	55,537,317
Other liabilities	5,073,290	8,706,711
Accumulated appropriations for losses	16,596,986	13,327,099

Capital Funds

	1977	1976
Debentures issued and outstanding (note 1)	30,000,000	—
Capital Stock:		
Authorized—8,000,000 shares, par value $5 each; issued and fully paid—8,000,000 shares	40,000,000	40,000,000
Rest account	27,000,000	21,000,000
Undivided profits	992,059	1,367,152
Total capital funds	97,992,059	62,367,152
	$2,063,179,583	$1,708,093,219

Walter A. Prisco
Executive Vice President & Chief General Manager

Statement of Revenue, Expenses and Undivided Profits

For the Financial Year Ended October 31, 1977
(with comparative figures for 1976)

	1977	1976
Revenue:		
Income from loans	**$135,050,055**	$126,669,498
Income from securities	**23,462,922**	16,023,032
Other operating revenue	**9,155,574**	7,148,675
Total revenue	**167,668,551**	149,841,205
Expenses:		
Interest on deposits	**130,174,404**	113,520,904
Salaries, pension contributions and other benefits	**8,501,063**	7,301,254
Property expenses including depreciation	**2,724,568**	2,262,596
Other operating expenses, including provision for losses on loans based on five-year average loss experience	**9,314,609**	6,174,348
Total expenses	**150,714,644**	129,259,102
Balance of revenue	**16,953,907**	20,582,103
Provision for income taxes relating thereto (note 2)	**2,909,000**	6,674,000
Balance of revenue after provision for income taxes	**14,044,907**	13,908,103
Appropriation for losses, net of income taxes related thereto	**2,420,000**	3,700,000
Balance of profits for the year	**11,624,907**	10,208,103
Dividends	**6,000,000**	6,001,911
Amount carried forward	**5,624,907**	4,206,192
Undivided profits at beginning of year	**1,367,152**	3,887,660
	6,992,059	8,093,852
Transferred to Rest Account	**6,000,000**	6,726,700
Undivided profits at end of year	**$ 992,059**	$ 1,367,152
Balance of revenue per share after provision for income taxes based on average shares outstanding	**$1.76**	$1.74
Balance of profits per share based on average shares outstanding	**$1.45**	$1.28

See notes to financial statements.

Statement of Accumulated Appropriations for Losses

For the Financial Year Ended October 31, 1977
(with comparative figures for 1976)

	1977	1976
Accumulated appropriations at beginning of year:		
Tax-paid	**$ 1,603**	$ 1,603
General	**13,325,496**	7,991,837
Total	**13,327,099**	7,993,440
Add (deduct):		
Appropriation from current year's operations, net of income taxes related thereto as set out below	**2,420,000**	3,700,000
Loss experience on loans less provision included in other operating expenses	**(1,589,347)**	(1,947,972)
Profits and losses on securities, including provisions to reduce securities other than those of Canada and its provinces to values not exceeding market	**319,234**	141,631
Income tax credit related to appropriation from current year's operations	**2,120,000**	3,440,000
Accumulated appropriations at end of year	**$16,596,986**	$13,327,099
Tax-paid	**$ 7,940**	$ 1,603
General	**16,589,046**	13,325,496
	$16,596,986	$13,327,099

See notes to financial statements.

Statement of Rest Account

For the Financial Year Ended October 31, 1977
(with comparative figures for 1976)

	1977	1976
Balance at beginning of year	**$21,000,000**	$14,398,300
Expenses of capital stock issue, net of income taxes relating thereto	—	(125,000)
Transferred from undivided profits	**6,000,000**	6,726,700
	6,000,000	6,601,700
Balance at end of year	**$27,000,000**	$21,000,000

See notes to financial statements.

Notes to Financial Statements

October 31, 1977

	1977	1976
1. Debentures issued and outstanding:		
9% debentures maturing January 3, 1997. The debentures are redeemable at the holders' option on January 3, 1987 provided the option is exercised between January 15 and July 15, 1986. Pursuant to the applicable provisions of the Bank Act and the Trust Indenture, the debentures are subordinate in right of payment to the deposit liabilities and certain other liabilities of the Bank.	**$30,000,000**	—
2. The aggregate provision for income taxes is made up as follows:		
In respect of balance of revenue	**$ 2,909,000**	$6,674,000
In respect of current appropriations for losses (credit)	**(2,120,000)**	(3,440,000)
In respect of expenses of capital stock issue (Rest Account)	—	125,000
	$ 789,000	$3,359,000

Auditors' Report to the Shareholders

We have examined the statement of assets and liabilities of The Mercantile Bank of Canada as at October 31, 1977 and the statements of revenue, expenses and undivided profits, accumulated appropriations for losses and rest account for the year ended on that date. Our examination included a general review of the accounting procedures and such tests of accounting records and other supporting evidence as we considered necessary in the circumstances.

In our opinion, the foregoing statements present fairly the financial position of the Bank as at October 31, 1977 and the revenue, expenses, changes in undivided profits, accumulated appropriations for losses and rest account of the Bank for the year ended on that date.

J. S. Grant, C.A.
of Peat, Marwick, Mitchell & Co.

G. Amideneau, C.A.
of Maheu, Noiseux & Associés

Montreal, Quebec
November 24, 1977

Ten Year Statistical Review

	1977
Statement of Revenue, Expenses and Undivided Profits as at October 31	**$**
Revenue:	
Income from loans	135,050,055
Income from securities	23,462,922
Other operating revenue	9,155,574
Total revenue	167,668,551
Expenses:	
Interest on deposits	130,174,404
Salaries, pension contributions and other benefits	8,501,063
Property expenses including depreciation	2,724,568
Other operating expenses, including provision for losses on loans based on five-year average loss experience	9,314,609
Total expenses	150,714,644
Balance of revenue	16,953,907
Provision for income taxes relating thereto	2,909,000
Balance of revenue after provision for income taxes	14,044,907
Appropriation for losses, net of income taxes related thereto	2,420,000
Balance of profits for the year	11,624,907
Dividends	6,000,000
Balance of revenue per share after provision for income taxes based on average shares outstanding (note)	$1.76
Balance of profits per share based on average shares outstanding (note)	$1.45
Condensed Statement of Assets and Liabilities as at October 31	
Assets:	
Cash resources	114,016,414
Government and other securities	336,745,062
Loans, including mortgages	1,554,384,320
Bank premises	4,245,636
Customers' liability under acceptances, guarantees and letters of credit as per contra	48,903,794
Other assets	4,884,357
Total assets	2,063,179,583
Liabilities and Capital:	
Deposits	1,894,613,454
Acceptances, guarantees and letters of credit	48,903,794
Other liabilities	5,073,290
Accumulated appropriations for losses	16,596,986
Total capital funds	97,992,059
Total liabilities and capital	2,063,179,583

NOTE:
Per share figures have been adjusted to reflect a two for one share split in 1972 and six issues of new shares during the period from March 30, 1972 to April 14, 1975.

1976	1975	1974	1973	1972	1971	1970	1969	1968
$	$	$	$	$	$	$	$	$
126,669,498	78,912,454	60,570,599	36,138,972	21,654,146	16,082,159	16,905,196	14,760,395	12,167,164
16,023,032	8,280,917	7,875,458	2,620,348	1,157,102	1,424,983	1,326,407	706,575	947,918
7,148,675	6,961,293	5,805,109	3,099,738	2,029,571	1,653,905	835,275	1,065,395	1,260,852
149,841,205	94,154,664	74,251,166	41,859,058	24,840,819	19,161,047	19,066,878	16,532,365	14,375,934
113,520,904	63,250,174	57,641,229	28,033,069	13,802,058	9,987,363	12,118,091	10,260,419	8,817,508
7,301,254	5,782,380	4,448,788	3,432,453	3,024,282	2,859,442	2,920,762	2,688,980	2,410,999
2,262,596	2,029,201	1,642,455	1,256,339	1,193,799	946,564	931,637	851,986	748,547
6,174,348	4,522,565	3,515,570	2,596,714	2,117,287	1,547,257	1,592,345	1,282,076	1,455,335
129,259,102	75,584,320	67,248,042	35,318,575	20,137,426	15,340,626	17,562,835	15,083,461	13,432,389
20,582,103	18,570,344	7,003,124	6,540,483	4,703,393	3,820,421	1,504,043	1,448,904	943,545
6,674,000	7,168,000	1,873,000	2,756,000	2,095,000	1,935,000	495,000	—	—
13,908,103	11,402,344	5,130,124	3,784,483	2,608,393	1,885,421	1,009,043	1,448,904	943,545
3,700,000	2,500,000	300,000	200,000	150,000	100,000	415,290	1,448,904	943,545
10,208,103	8,902,344	4,830,124	3,584,483	2,458,393	1,785,421	593,753	—	—
6,001,911	5,859,024	4,493,332	3,398,869	2,275,000	1,750,000	—	—	—
$1.74	$1.57	$0.89	$0.89	$1.01	$0.94	$0.50	$0.72	$0.47
$1.28	$1.22	$0.83	$0.84	$0.95	$0.89	$0.30	—	—
93,819,781	72,384,304	34,728,924	23,991,182	16,018,236	18,218,169	10,236,599	14,171,026	20,552,264
309,233,551	172,235,851	123,638,717	82,571,877	24,934,049	16,974,714	12,569,247	9,802,994	14,704,337
1,243,839,064	992,029,562	498,400,105	450,920,000	332,952,363	242,220,746	162,880,562	164,545,739	147,121,460
3,256,169	2,676,771	2,426,178	1,772,181	1,767,449	1,152,741	1,309,754	1,301,236	1,120,682
55,537,317	44,332,403	33,158,751	25,515,104	13,254,107	9,296,374	5,141,385	4,065,795	4,453,873
2,407,337	4,503,676	6,545,316	2,473,760	1,077,874	611,437	438,903	483,183	593,423
1,708,093,219	1,288,162,567	698,897,991	587,244,104	390,004,078	288,474,181	192,576,450	194,369,973	188,546,039
1,568,154,940	1,138,843,282	620,459,651	522,155,648	350,994,785	260,032,638	169,001,111	174,365,176	164,730,953
55,537,317	44,332,403	33,158,751	25,515,104	13,254,107	9,296,374	5,141,385	4,065,795	4,453,873
8,706,711	38,707,482	940,293	2,929,725	3,478,898	4,298,588	1,650,275	505,877	5,400,393
13,327,099	7,993,440	3,088,656	2,637,779	2,280,354	1,708,040	1,180,559	2,923,758	1,451,453
62,367,152	58,285,960	41,250,640	34,005,848	19,995,934	13,138,541	15,603,120	12,509,367	12,509,367
1,708,093,219	1,288,162,567	698,897,991	587,244,104	390,004,078	288,474,181	192,576,450	194,369,973	188,546,039

Twenty-Fourth Annual General Meeting of the Shareholders

MINUTES of the Twenty-Fourth Annual General Meeting of the Shareholders of The Mercantile Bank of Canada held at The Queen Elizabeth Hotel, Montreal, on Wednesday, the 14th day of December, 1977, at 10:00 o'clock of the forenoon.

The Chairman of the Bank, Mr. G. A. Costanzo, presided and the Secretary, Mr. W. T. Livingstone, acted as Secretary of the Meeting. In opening the Meeting, the Chairman introduced the officers present with him on the platform and also the Directors present at the Meeting.

The notice of the Meeting having been sent to all Shareholders entitled to receive it and a quorum being reported present, the Chairman declared the Meeting to be duly convened and constituted.

With the consent of the Meeting, the Chairman appointed Mrs. R. E. Heard and Mrs. A. Meyer, both of The Royal Trust Company, to act as Scrutineers.

Upon motion of Mr. A. Bachand, seconded by Mr. H. A. Benham and carried, the Minutes of the last Annual Meeting held on December 8, 1976, were taken as read and confirmed.

The Chairman then asked the Secretary to read the Directors' Report to the Shareholders, omitting the Annual Statement and the Auditors' Report as these had already been sent to all Shareholders and copies were in the hands of those present.

Directors' Report

The Directors take pleasure in submitting to the Shareholders the Annual Statement of the Bank for the year ended October 31, 1977, together with the Auditors' Report.

In January, the Bank issued $30,000,000 in Debentures which were well received in the market. The proceeds of the issue were added to the funds of the Bank for its general banking business.

The number of branches has been increased to fourteen by the opening of one at Regina, Saskatchewan in May and one at Ottawa, Ontario in October.

In April, Mr. J. P. Murphy resigned as President and as a Director of the Bank to take up an assignment with Citibank, N.A. The Directors record their sincere appreciation of Mr. Murphy's services to the Bank during his term as its Chief Executive Officer. His successor is Mr. R. L. Davidson, formerly Citibank's senior officer in Japan.

With much regret, the Directors report that Mr. H. T. Mitchell, who has been a Director of the Bank since 1966, will not stand for re-election this year, having reached the mandatory retirement age pursuant to the provisions of the Bank Act. Mr. Mitchell's devoted interest in the Bank's affairs and his wise counsel have been much appreciated; he will be greatly missed. Since the last Annual General Meeting, Mr. L. R. Desmarais of Montreal was appointed a Director.

The loyal and efficient services of the staff are gratefully and sincerely acknowledged.

G. A. Costanzo
Chairman

Montreal, December 14, 1977

The Chairman said that before moving the adoption of the Directors' Report he would ask the President, Mr. Robert L. Davidson, to address the Meeting and would then ask Mr. Bernard J. Goyette, Senior Vice-President, Eastern Division, to deliver the report on the Bank's operations, in the absence of Mr. Walter A. Prisco, Executive Vice-President and Chief General Manager.

(The President's address and the Chief General Manager's report are reproduced on pages two and four respectively.)

It was moved by the Chairman and seconded by Mr. L. R. Desmarais —

THAT the Directors' Report to the Shareholders, including the Annual Statement and the Auditors' Report thereon, in respect of the Bank's fiscal year ended October 31, 1977, be and the same is hereby approved and adopted.

The Chairman proposed that the ballot on this motion be taken later in the Meeting.

Auditors

It was moved by Mr. E. D. H. Wilkinson and seconded by Mr. H. H. Stikeman —

THAT Mr. John S. Grant, C.A. and Mr. Charles-Albert Poissant, C.A. be appointed Auditors of the Bank for the current year and that their remuneration in that capacity be not more than $55,000.

The Chairman proposed that the ballot on this motion be taken later in the Meeting.

Directors

The Chairman said that pursuant to Shareholders' By-Law IV, the number of Directors had been increased during the year to seventeen and subsequently reduced to sixteen, and it was proposed that all eligible Directors be re-elected.

At the request of the Chairman, the Secretary then read the names of the persons proposed for election as Directors, namely: A. Bachand, H. A. Benham, G. A. Costanzo, R. L. Davidson, C. W. Desch, L. R. Desmarais, M. Franklin, J. T. Johnson, R. F. B. Logan, B. R. B. Magee, A. T. Seedhouse, R. D. Southern, H. A. Steinberg, H. H. Stikeman, J. H. Taylor, E. D. H. Wilkinson.

Miss V. M. Henderson then nominated the persons whose names had been read by the Secretary for election as Directors of the Bank for the ensuing year.

The Chairman then directed that a ballot be taken on the motions to adopt the Directors' Report, to appoint Auditors and for the election of Directors. Upon receiving the report of the Scrutineers, the Chairman declared that the resolutions adopting the Directors' Report and appointing Auditors had been duly passed and that the persons whose names had been read by the Secretary, and duly nominated, had been elected Directors.

The Meeting then terminated.

G. A. Costanzo
Chairman

W. T. Livingstone
Secretary

At the subsequent Meeting of the Board of Directors the following officers were elected:

- Chairman — G. A. Costanzo, President and Chief Executive Officer — R. L. Davidson, Vice-President — A. T. Seedhouse.
- W. A. Prisco continues as Executive Vice-President and Chief General Manager.

Left to right: H. A. Steinberg, R. D. Southern, J. H. Taylor, H. T. Mitchell, J. T. Johnson, Q.C., R. L. Davidson, G. A. Costanzo, A. T. Seedhouse, C. W. Desch, M. Franklin, H. A. Benham, E. D. H. Wilkinson, Q.C., A. Bachand, R. F. B. Logan and L. R. Desmarais. (B. R. B. Magee and H. H. Stikeman, Q.C. not pictured.)

Board of Directors and Executive Officers

Board of Directors

Chairman
G. A. Costanzo, New York
Vice Chairman
Citibank, N.A.

President & Chief Executive Officer
Robert L. Davidson, Montreal

Vice President
Alfred T. Seedhouse, Toronto
Chairman
The Manufacturers Life Insurance Company

André Bachand, Montreal
Director
Development Fund
University of Montreal

Hugh A. Benham, Winnipeg
Investment Counsel

Carl W. Desch, New York
Senior Vice President & Cashier
Citibank, N.A.

Louis R. Desmarais, Montreal
Chairman
The Council for Canadian Unity

Mitchell Franklin, Saint John
President
Franklin Group of Companies

John T. Johnson, Q.C., Toronto
Partner
Borden & Elliot

Robert F. B. Logan, New York
Senior Vice President
Citibank, N.A.

Brian R. B. Magee, Toronto
Honorary Chairman
A. E. LePage Limited

Ronald D. Southern, Calgary
President & Chief Executive Officer
Atco Industries Ltd.

H. Arnold Steinberg, Montreal
Executive Vice President
Administration and Finance
Steinberg's Limited

H. Heward Stikeman, Q.C., Montreal
Senior Partner
Stikeman, Elliott, Tamaki, Mercier & Robb

John H. Taylor, Toronto
Chairman
North American Life Assurance Company

Edward D. H. Wilkinson, Q.C., Vancouver
Partner
Russell & DuMoulin

Executive Officers

President & Chief Executive Officer
Robert L. Davidson

Executive Vice President & Chief General Manager
Walter A. Prisco

Senior Vice Presidents
T. Sean Ahern
Administration

Patrick F. Bowditch
Credit

Duncan Campbell
Western Division

Bernard J. Goyette
Eastern Division

John E. Pierce
Central Division

Vice Presidents
Harvey Elman
Real Estate

David W. Franzen
Personnel

John R. Groves
Corporate Planning

Gregory R. Latremoille
Investment & Exchange
Regional Office, Toronto

William T. Livingstone
Secretary
Corporate Functions & Public Relations

Larry Pirnak
Training & Development

Raymond M. Roy
Investment & Exchange

James A. W. Van Slyck
International Division

Myron Zbyradowski
Foreign Exchange

Chief Inspector
Maurice M. Christens

Deputy General Manager
Heinz K. Weindler
Accounting

Head Office and Branches

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625 Dorchester Boulevard West
Montreal, Quebec
(514) 871-2500

Eastern Division
Montreal Branch
625 Dorchester Boulevard West
(514) 871-2500

Dennis L. Frizzell
Vice President

J. Brian Sullivan
Vice President

Ottawa Branch
350 Sparks Street
(613) 238-8385

Gilles Séguin
Vice President

Quebec City Branch
580 Grande Allée East
(418) 647-2921

Jean A. Plamondon
Manager

Halifax Branch
1681 Granville Street
(902) 429-3030

C. Dominick Williams
Manager

Saint John Branch
2 King Street
(506) 657-5790

James McCallion
Manager

Central Division
120 Adelaide Street West
Toronto
(416) 361-7200

Allan E. Jenner
Vice President
Western Ontario

Toronto Branch
120 Adelaide Street West
(416) 361-7200

James S. Parsons
Vice President

Kitchener Branch
22 Frederick Street
(519) 579-4680

Jack O. Kiervin
Manager

Hamilton Branch
47 James Street South
(416) 526-0670

J. Scott Shelly
Manager

London Branch
272 Dundas Street
(519) 679-0901

Stephen D. Barlow
Manager

Western Division
Vancouver Branch
1177 West Hastings Street
(604) 684-8411

Brian McL. Romer
Vice President

Calgary Branch
441, 5th Avenue, S.W.
(403) 262-6961

Hermann G. Bessert
Vice President

Ian D. R. Neilson
Manager, Oil &
Gas Department

Edmonton Branch
10030 Jasper Avenue
(403) 424-3161

Jean G. Fournet
Vice President

Regina Branch
1863 Victoria Avenue
(306) 525-9161

Lloyd M. Craig
Vice President

Winnipeg Branch
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Bryan A. Dudek
Vice President

Los Angeles Representative Office
515 South Flower Street
(213) 488-0166

Donald A. Anderson
Representative

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Printed in Canada